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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

EX PARTE

August 17, 1998

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, N.W. Room 222
Washington, D.C. 20554

RE: In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45 and Forward-Looking Mechanism for Non-Rural LECs, CC Docket No. 97-160

Dear Ms. Salas:

On August 13, 1998, representatives of Sprint Corporation met with Commissioner Pat Wood of the Texas Public Service Commission to discuss the above referenced proceedings. The attached materials were covered in the meeting. Representing Sprint Corporation were Jim Sichter, Sue McCanless and Brad Denton.

Sprint requests that this information be made a part of the record in this matter. Four copies of this letter, in accordance with Section 1.1206(a)(1), are provided for this purpose. If you have any questions, please feel free to call.

Sincerely,

Melinda Mills

Melinda L. Mills

Attachment

Sprint.

SPRINT'S UNIVERSAL SERVICE FUND PROPOSAL

Presented to Chairman Wood

August 13, 1998

Jim Sichter 913/624-1303
Sue McCanless 913/534-3131

Sprint.

- **Existing, implicit subsidies must be eliminated. To the extent that subsidies are required, they should be funded through an explicit, competitively neutral USF.**

  - The elimination of implicit subsidies is required by the Telecommunications Act of 1996.

  - Existing, implicit access subsidies:

    - are not competitively neutral (only IXCs/toll users fund subsidies);

    - thwart facilities-based local competition; and

    - uneconomically and inequitably burden long distance users.

Sprint.

- **Current rate structures impede facilities-based local competition, particularly in the residential market.**

Percent Customers who are Profitable to Serve*
(Sprint LTD Data)

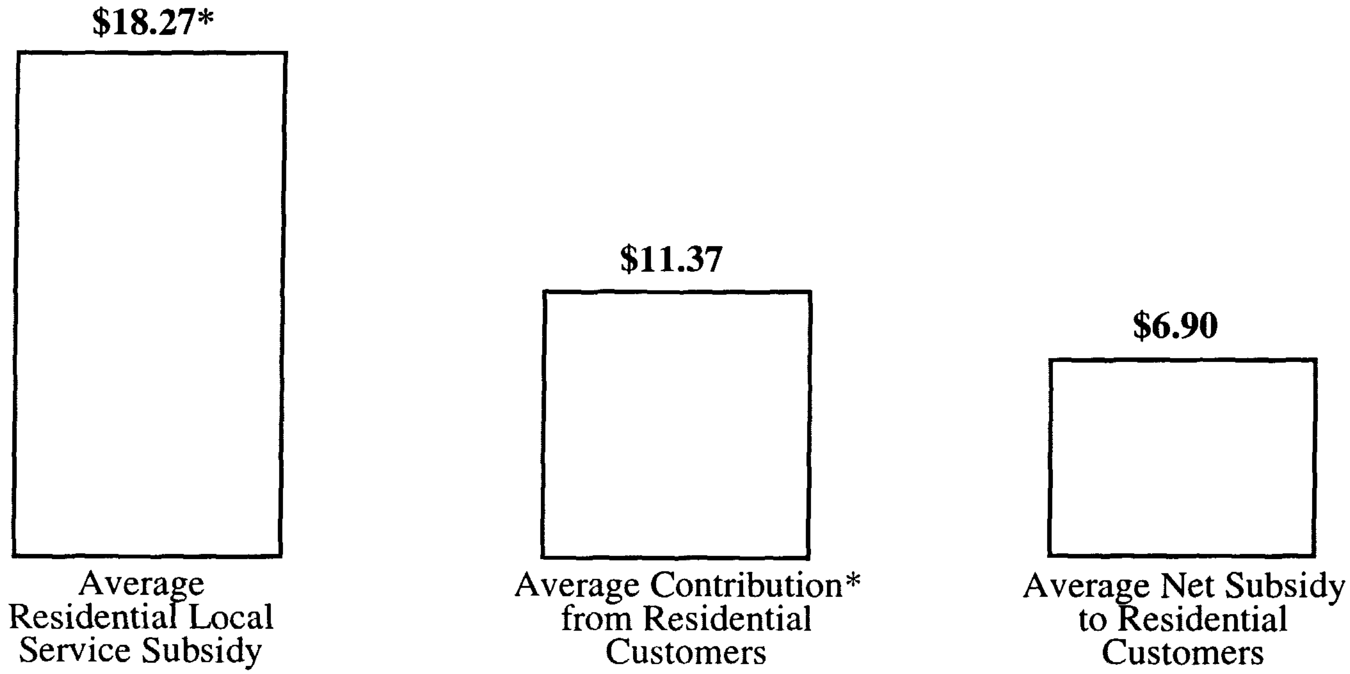
	Residential	Business
Total	29%	77%
Low Cost Areas (Local Service Costs ≤ $25)	52%	99%
[Percent of Total Customers in Low Cost Areas]	[27%]	[39%]

******Comparison of total revenues guaranteed by customers to the total cost of service, based on BCPM with FCC inputs.***

◆ **As a subsidy mechanism for universal service, the current rate structure is highly inefficient; a large proportion of the subsidy is paid by those customers who are intended to be the beneficiaries of subsidies.**

- Based on a study of Sprint LTD customers, over half of the subsidy to residential local service is provided by residential customers

  ◆ At the cost of highly inefficient prices



** Includes interLATA and intraLATA access and features.*

Sprint.

- **As a subsidy mechanism for universal service, the current rate structure is highly inefficient, large proportion of the subsidy is paid by those customers who are intended to be the beneficiaries of subsidies.**
  - Low income consumers also utilize toll services, and thereby contribute to as well as receive subsidies.

Expenditures on Long Distance Bill*

HH Income Group	% of H	Average LD Bill
Under 10K Annually	11.1	$16.17
$10K-$19,999	18.9	$19.11
$20K-$29,999	18.8	$21.94
$30K-$39,999	15.3	$21.73
$40K-$49,999	10.8	$20.09
$50K-$74,999	19.1	$26.80
$75K-$99,999	3.7	$27.51
$100K and Over	2.3	$28.78

** Source: PNR Bill Harvesting*

Sprint.

- **Principles upon which the federal USF plan should be based:**

  - Support should be based on forward looking costs.

    - Using a forward-looking cost methodology as the starting point in calculating the support amount is appropriate since it enables the Commission to arrive at a rate that emulates competitive market conditions. Facilities-based competition will not develop unless the sum of revenues and subsidies is predictable and accurate. Using forward-looking costs is the only way the marketplace will send the correct signals to potential entrants.

      - If costs are over-estimated, that will attract inefficient entry that should not occur.

      - If costs are under-estimated, that will discourage efficient entry that should occur.

Sprint.

- **Federal USF should be a national fund, based on both state and interstate retail revenues**

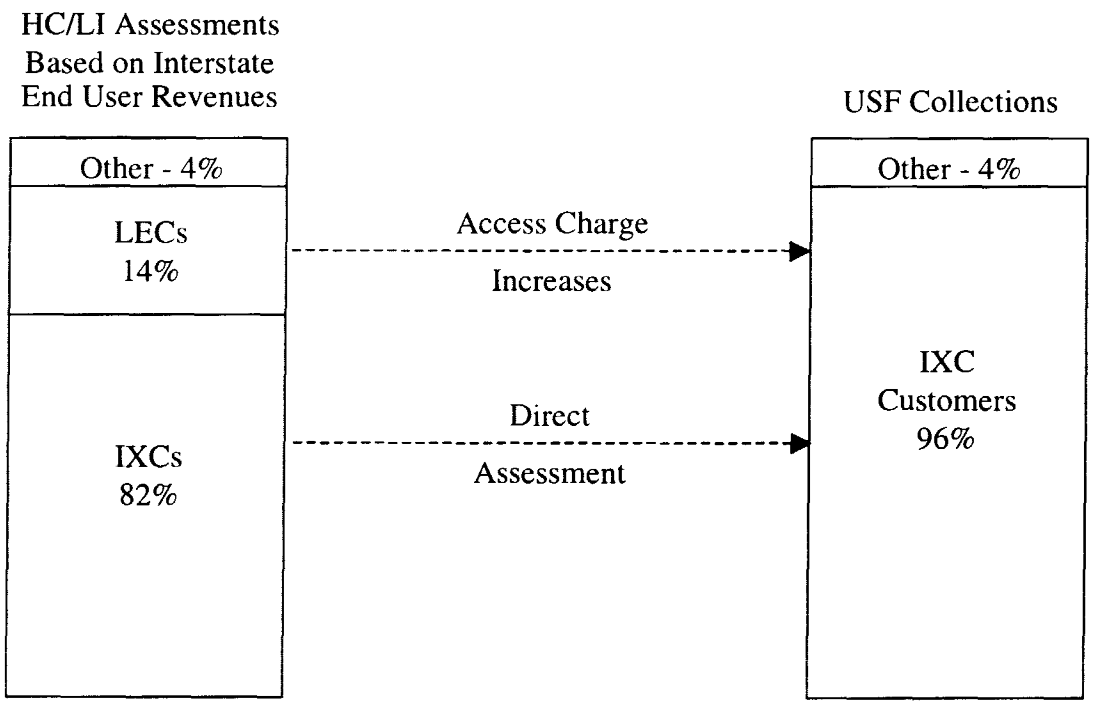
  - The Commission has stated, both in its May 8th Order and in its recent Report to Congress, that Section 254 grants it the authority to create a national fund made up of contributions from intrastate as well as interstate revenues.

  - In order to ensure competitive neutrality, as well as sufficient support flow between states, a national fund is not only reasonable, but essential.

Sprint.

- **Assessing USF contributions on only interstate revenues effectively imposes the entire burden of USF support on interstate toll customers.**

  - Especially with LECs flowing their obligations through to IXCs in the form of higher access charges.



Sprint.

- **A National USF Fund Based on <u>Total</u> Retail Revenues**
  - Provides the broadest basis of support
    - Minimizing the burden on any particular service or jurisdiction
  - Is competitively neutral
- **Although concerns about cross-state subsidy flows (e.g., customers in low-cost states having to subsidize customers in high-costs states) are legitimate, it must be recognized that such <u>cross-state subsidy flows exist today</u>, in the form of the implicit subsidies built into access.**
  - Rationalization of those subsidy flows can benefit customers in all states.

Sprint.

- **Where a cost-based rate might be considered prohibitive, the federal benchmark should be based on the maximum *affordable* local service rate.**

  - Since the benchmark is intended to be a measure of "affordability" the appropriate standard is the basic local service rate, not average revenues.

  - Income considerations should be excluded, since low income households are addressed directly through the Lifeline/Link-up programs.

  - The federal benchmark rate should be set at a level representing the maximum affordable local service rate - a rate which is considerably higher than the below-cost local service rates that exist today.

Sprint.

- **USF should be narrowly targeted to high cost areas**
  - Sprint believes that costs and support should be determined on a census block group level.
- **USF support should be equally available to all Eligible Telecommunications Carriers (ETCs)**
- **Implementation of the plan should be revenue neutral at its inception**
  - Any new USF funding (i.e., funding in excess of current levels of high cost support) to a company should be offset, dollar-for-dollar, with reductions in access charges.

Sprint.

- **USF fund obligations should be recovered through a surcharge on end users' retail charges.**

  - The end user surcharge is the key to any workable USF plan. Without it, competitive neutrality, both in terms of contribution levels and recovery, is a virtual impossibility.

  - Because implicit subsidies exist today, end users are already supporting the universal service fund. Consequently, the removal of these implicit subsidies, replaced with the explicit surcharge, will not result in an overall increase in consumer charges.

Sprint.

- USF support can be phased-in to minimize the customer surcharge
  - Total industry retail revenues are growing at approximately 12% per year.
  - Whereas access lines are growing at only 4.3% a year.
    - And USF-eligible access lines (i.e., access lines in rural, high-cost areas) may be growing less than the average.

	1998	1999	2000	2001	2002	2003	2004
Total Retail Revenues (Billions)	$188	$211	$236	$264	$296	$331	$371
USF Support available with 3% surcharge (Billions)	$5.6	$6.3	$7.1	$7.9	$8.9	$9.9	$11.1

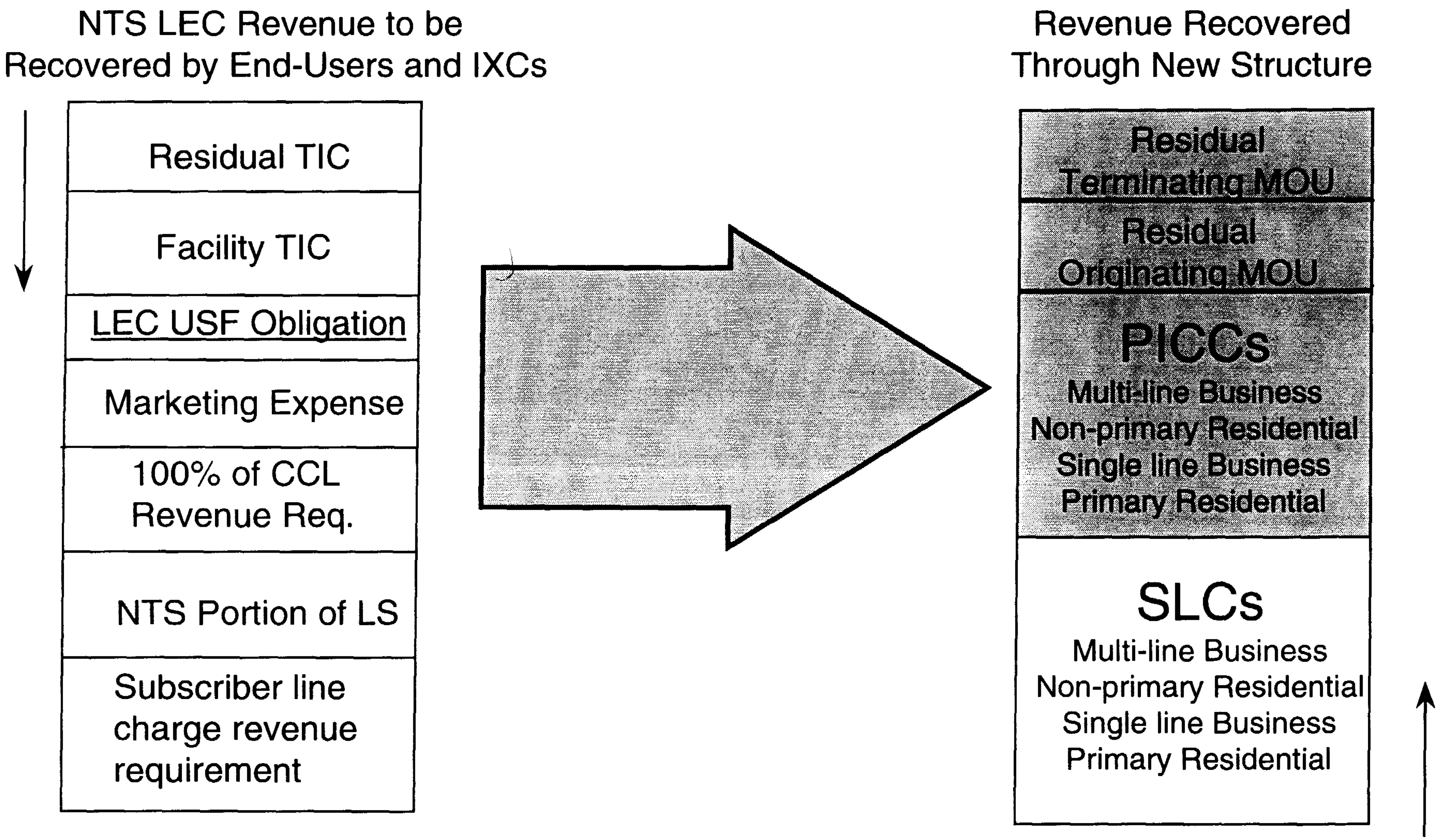
Sprint.

- **States are free to adopt intrastate USF plans if they desire**

  - Employing a lower benchmark affordable rate, the state plan would act as a safety net for those areas where the federal benchmark rate may, in the state's opinion, prove burdensome.

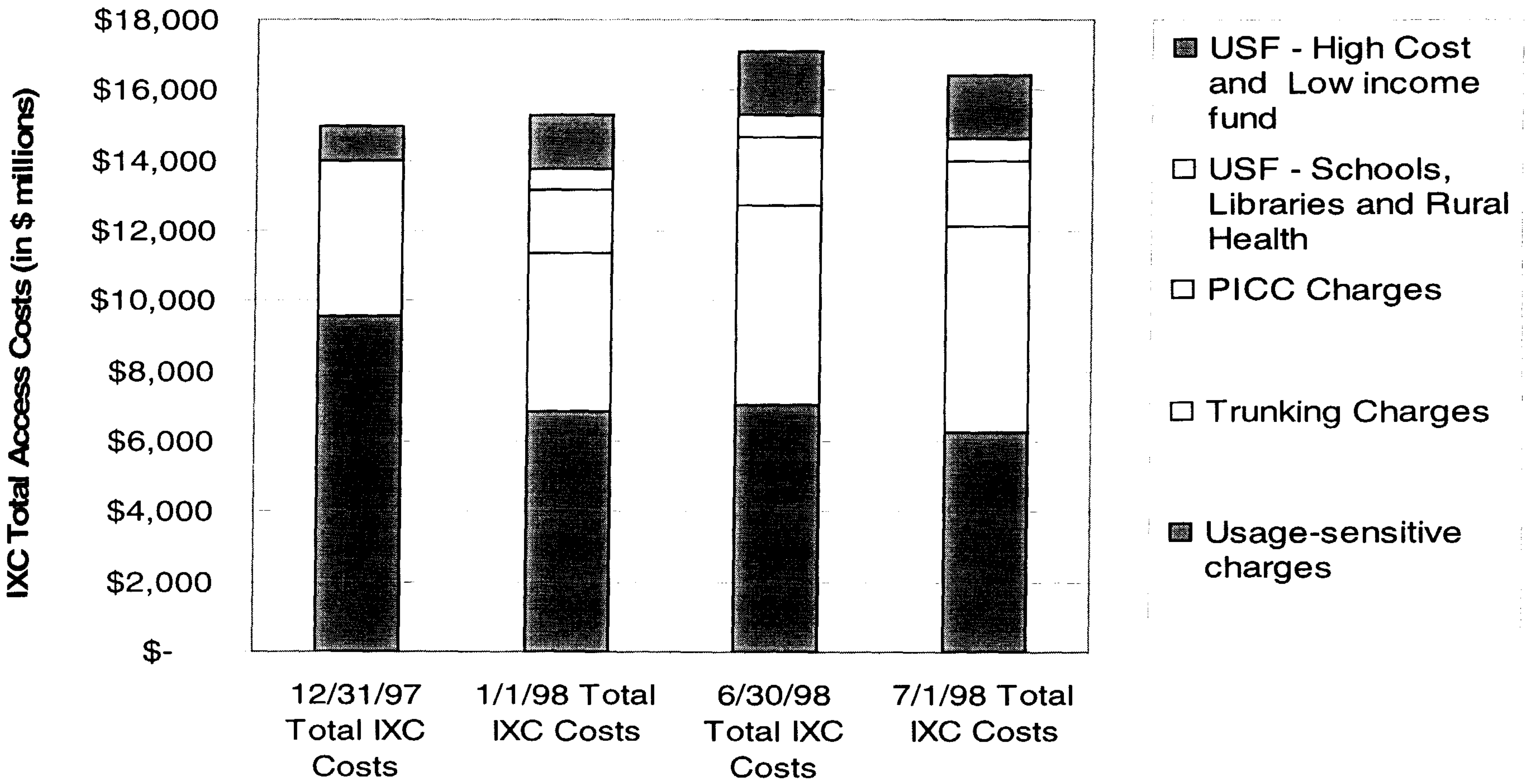
  - Funding for state plans must come solely from intrastate retail revenues.

Sprint. Federal Access/Universal Service Reform - Mechanics



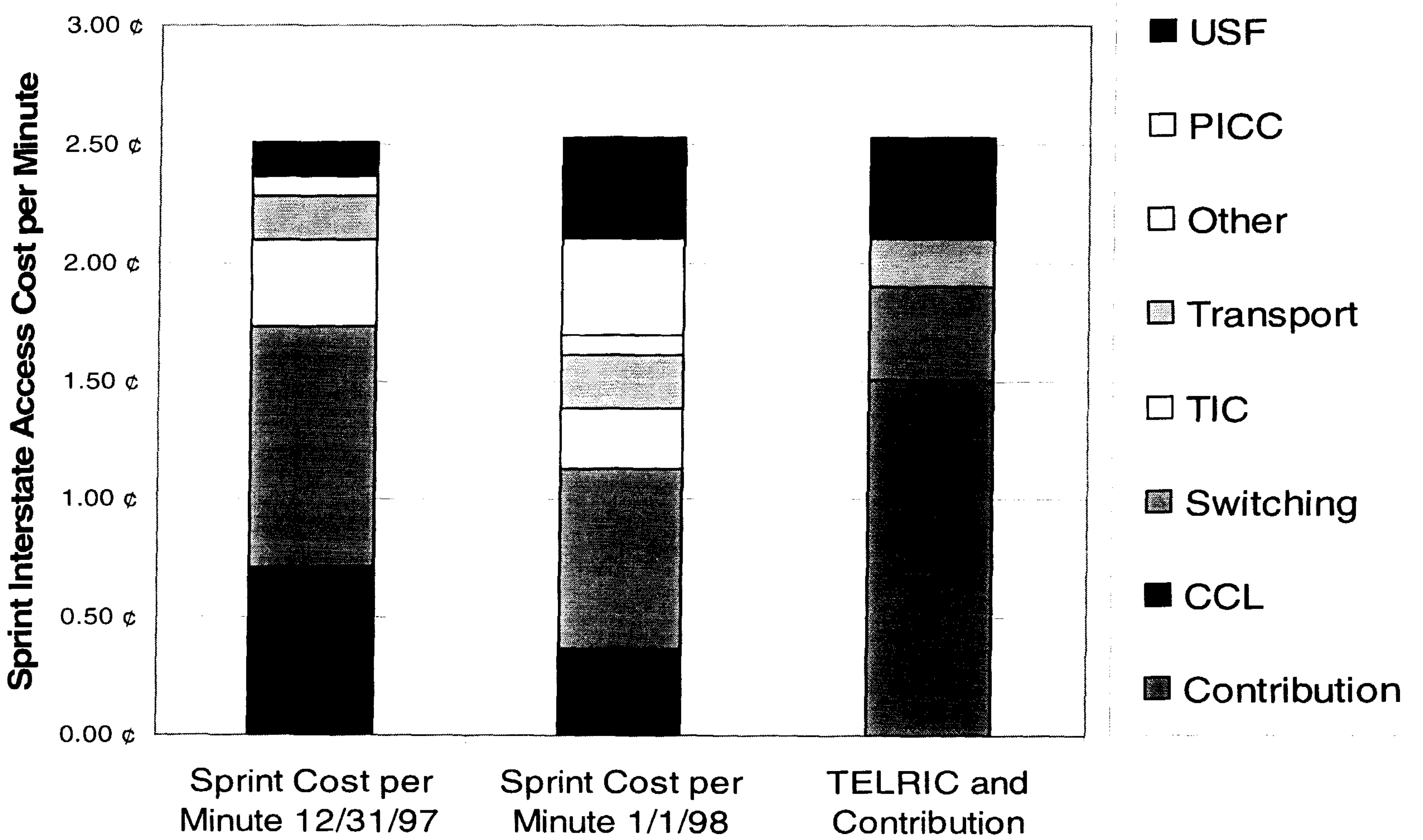
All carriers also contribute to USF based on a percentage of retail revenues. LECs can recover their contribution from IXCs in access charges.

IXC Financial Impact



Note: USF contributions reflect the amount for that time period. The first two columns reflect 1996 base demand, while the last two reflect 1997 base demand as updated in the 7/1/98 filings.

Impact of Access and Universal Service Reform on Sprint's Interstate Access Cost per Minute



REVIEW OF GTE'S UNIFORM PRICING PROPOSAL

We have completed our review of the GTE "Uniform Pricing" proposal. While we certainly appreciate GTE's effort to craft a solution, Sprint believes GTE's proposal is flawed on both theoretical and practical grounds. We outline these concerns below.

Sprint remains convinced that access flow through is a "perception" issue. Actual long distance prices have decreased in excess of access reductions in the past and will continue to do so in the future. The fact that long distance rates for all services have not been reduced proportionately has given rise to erroneous allegations that access charge reductions have not been flowed through. However, implementation of a uniform pricing proposal would tend to harm the working of the competitive process to the detriment of consumers and providers.

Most industry observers we talk with envision a new Universal Service Fund (USF) based on a general framework designed to achieve two goals: minimize total consumer payments for universal service so that consumers are actually paying for universal service and not for something else and collect universal service payments in a non-intrusive (and explicit), but competitively neutral way. ILECs would price access services at TELRIC- based rate levels and model the difference between underlying loop costs and appropriate local service revenues to determine the amount of universal service funding. Sprint, like many others, believes that universal service should be funded explicitly through a surcharge on customer bills. Sprint and GTE agree that the FCC is required to establish an explicit, competitively neutral support mechanism for universal service and in doing so must eliminate today's system of implicit support. This change may cause changes to individual consumer bills based on usage levels. Those with low volumes may see an increase while those with relatively higher volumes may see a decrease.

GTE attempts to address this concern through its proposal by creating an incentive plan under which IXCs would voluntarily pass through access reductions in a uniform way. As we understand the GTE proposal, there would essentially be two interstate access tariffs in place, Schedule A and Schedule B. IXCs would be able to order access out of Schedule A for a particular ILEC only if the IXC applied the reductions uniformly across-the-board to all customers. That reduction would have to be separately listed on the bill and not included in the rates of the IXC. IXCs that would not agree to these conditions could only order access out of Schedule B. Presumably all IXCs (500+ of them?) would agree to this proposal in order to receive from all ILECs (CLECs?) the access reductions made possible through USF changes.

At first glance, this may appear to be a straightforward approach. The problem though is that uniform pricing creates its own set of problems, further exacerbating the harm caused by the existence of untargeted subsidies. Sprint suggests a different approach, but first we outline the reasons why a uniform pricing proposal will not work.

Apart from any legal discriminatory challenges such a tariff would likely bring, there are two basic problems with the uniform credit mechanism.

First, there **is** a direct connection between an individual consumer's purchase of long distance service and the associated access configuration or access cost of providing service. Said differently, the access cost of providing service to individual consumers is non-uniform; any access cost decrease will affect consumers differently based on the services they buy.

Second, access costs are just one of the factors in the IXC's overall pricing calculus. The uniform pricing proposal would not only interfere with the relationship between customer prices and customer costs regarding access, but it would also interfere with the normal, non-access cost driven market pricing strategies in which all IXCs, in fact, all competitive firms, engage. We attempt to explain each of these in more detail below.

To understand the first concern, assume two different consumers, the first makes 100 minutes of domestic interstate MTS calling and the second makes 100 minutes of international calling in a month. Assume that MTS is priced by IXC A at 20 cents/minute while international is priced at 50 cents/minute. Assume these relative prices reflect competitive market conditions. Consumer A would thus pay $20.00 for long distance calling ($.20 times 100 minutes) while consumer B pays $50.00 for long distance calling ($.50 times 100 minutes). On average, consumer A is paying $.20/minute while consumer B is paying $.50/minute.

Assume that interstate access costs for IXC A total $.10/billed minute, $.05/billed minute on both the originating and terminating end of a call. IXC A uses interstate access on both ends of consumer A's domestic MTS minutes but uses only interstate access on the originating side of consumer B's international calls. This situation is depicted in the table labeled "Current Situation."

CURRENT SITUATION

"CONSUMER A"	Usage (Minutes)	Consumer/ Expenditure	Interstate Access Cost
Domestic MTS (@$.20/Minute)	100	$20.00	$10.00
International (@$.50/minute)	0	0	0
TOTAL	100	$20.00	$10.00

"CONSUMER B"	Usage (Minutes)	Consumer/ Expenditure	Interstate Access Cost
Domestic MTS (@$.20/Minute)	0	$0.00	$0.00
International (@$.50/minute)	100	$50.00	$5.00
TOTAL	100	$50.00	$5.00

Assume that as part of USF changes, all ILECs reduce access prices by 50% to $.025/billed minute. Under a uniform price reduction, IXC A would have to credit both consumer A and consumer B "uniformly," – presumably by the average access reduction. This situation is depicted in the table labeled "Implementation of Uniform Pricing." But note that consumer A's access configuration includes interstate switched access at both ends while consumer B's international usage includes switched access at only the originating end of the call(s). After the access reduction, the underlying interstate access cost **saving** of providing service to consumer A is $.05/minute while the interstate access cost **saving** of providing service to consumer B is $.025/minute. Cost based pricing would tend to make the domestic MTS price decline by $.05 from

$.20 to $.15 while the price of an international minute would only decline by $.025 from $.50 to $.475. Any deviation from this result would be sub-optimal. How would the uniform reduction proposed by GTE occur? Each of IXC A's customer bills would be reduced uniformly by the credit percentage on a uniform basis. IXC A's access cost per billed minute is a function of many factors, including mix of product, mix of customer type, choice of access configuration (switched access vs. special access) use of ILEC facilities vs. CLEC facilities, among other factors. We can assume in this example that the percentage for IXC A is 20%. In other words, IXC A's cost of access as a percentage of billed revenue declines by 20% meaning that each customer would receive a credit equal to 20% of billed revenue on a uniform basis.

IMPLEMENTATION OF UNIFORM PRICING AND USF

"CONSUMER A"	Usage (Minutes)	Consumer/ Expenditure	Interstate Access Cost
Domestic MTS (@$.20/Minute)	100	$20.00	$5.00
International (@$.50/minute)	0	0	0
TOTAL	100	$20.00	$5.00
Less: Uniform Flow Through (@ 20%)	0	$4.00	0
Net Consumer Expenditure	0	$16.00	0

"CONSUMER B"	Usage (Minutes)	Consumer/ Expenditure	Interstate Access Cost
Domestic MTS (@$.20/Minute)	0	$0.00	$0.00
International (@$.50/minute)	100	$50.00	$2.50
TOTAL	100	$50.00	$2.50
Less: Uniform Flow	0	$10.00	0

Through (@ 20%)			
Net Consumer Expenditure	0	$40.00	0

Thus, consumer A would receive a credit of $4.00 (20% of $20.00) lowering the after discount price of service to $.16/minute. Consumer B would also receive a 20% credit, lowering the bill to $40.00 or $.40/minute. This situation is shown in the table labeled "Impact" below. Contrast this to the competitive solution which would result in prices for consumer A of $.15/minute and for consumer B in prices of $.475/minute, reflecting a $.025/minute cost decrease on each end of a call. In effect, the uniform price reduction would lower the price of service for consumer A by 4 cents per minute and for consumer B by 10 cents per minute. The domestic user subsidizes the international user. Hardly a uniform price reduction. Are there any ways around this problem? As long as the uniform credit appears on the bill, there will be some users "subsidizing" other users. And this subsidy will not be based on any policy goals of the FCC or anyone else, but rather, the subsidy will be based on individual customer usage patterns.

IMPACT OF UNIFORM PRICING AND USF

	Consumer A	**Consumer B**
Consumer Savings	$4.00	$10.00
Consumer Savings/Minute	$0.04	$0.10
Interstate Access Cost Change	$5.00	$2.50
Interstate Access Cost Change/Minute	$0.05	$0.025

The second basic problem with the GTE approach is that it does not lend itself to the real world competitive marketplace.

Access costs are just one of many IXC costs that determine an IXC's prices and pricing strategy. Access costs are the largest single cost component and therefore are important. Because of the lack of widespread alternatives to ILEC access, especially for switched access, access costs continue to be priced at several multiples of TELRIC and therefore IXCs are engaged in efforts to attempt to find suitable alternatives to ILEC provided access. But consider that other factors play into an IXC's pricing strategy. At Sprint, for example, we run many pricing promotions around our affiliation with the National Football League, including Monday night special pricing and Prepaid FonCard (calling card) promotions. These pricing/promotions are scheduled around the NFL season, not around access charge changes. Access charge changes operate on a different schedule than the NFL does. Clearly, a uniform pricing proposal would cause havoc and interfere with our marketing plans for the NFL tie-in. Or consider that customer churn is a large non-access cost factor that drives customer costs. IXCs, and other firms operating in competitive markets, attempt to control this important cost in various ways, including pricing differences that reflect a customer's "loyalty." GTE's proposal would interfere with loyalty pricing by forcing IXCs to reduce prices proportionally for higher costing, higher churn customers as compared to lower costing, lower churn customers. This is not only potentially sub-optimal but more importantly, harms low-cost (low churn) customers.

IXCs have spent millions of dollars differentiating themselves from each other through marketing plans which include price differentials – MCI's "5 cent Sundays," AOL's "flat 9 cent calling plan" and Sprint's "Sprint Sense Anytime" come to mind. GTE's plan would tend to reduce the competitive ability of IXCs to respond to each other, and to the consuming public. IXCs would be forced to reduce rates for services that are not promoted or that already have very low margins. Further, the GTE proposal would require the reduction to be separately listed on the bill and not included in IXC rates. To the customer this would look like a tax rebate as opposed to lower IXC rates. It is